No. 108

In the Supreme Court of the United States

OCTOBER TERM, 1957

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

P. G. LAKE, INC.

FRANK SCOFIELD, FORMER COLLECTOR OF INTERNAL REVENUE, PETITIONER

v.

DENNIS M. O'CONNOR, ET AL.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

WM. FLEMING, ET AL.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JOHN WRATHER, ET AL.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

W. F. WEED, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE PETITIONERS

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OPINIONS BELOW

The opinion of the Tax Court in the *Lake* case (R. 13-14) is reported at 24 T. C. 1016. The opinion of the Court of Appeals (R. 16-27) is reported at 241 F. 2d 71.

The findings of fact and conclusions of law of the District Court in the *O'Connor* case (R. 74-78) are reported at 143 F. Supp. 240. The opinion of the Court of Appeals (R. 80-86) is reported at 241 F. 2d 65.

The findings of fact and opinion of the Tax Court in the *Fleming* case (R. 142-155) are reported at 24 T. C. 818. The opinion of the Court of Appeals (R. 180-189) is reported at 241 F. 2d 78.

The memorandum findings of fact and opinion of the Tax Court in the *Weather* case (R. 211-213) are not officially reported. The opinion of the Court of Appeals (R. 237-238) is reported at 241 F. 2d 84.

The findings of fact and opinion of the Tax Court in the *Weed* case (R. 252-261) are reported at 24 T. C. 1025. The opinion of the Court of Appeals (R. 262-264) is reported at 241 F. 2d 69.

All of the opinions (*supra*) are reproduced in the petition for certiorari at pp. 28-107.

JURISDICTION

The judgments of the Court of Appeals in all five cases were entered on February 1, 1957. (R. 27, 87, 190, 238-239, 265.) The petition for a writ of certiorari was filed April 17, 1957, and was granted June 3, 1957. The jurisdiction of this Court rests upon 28 U. S. C., Section 1254.

STATUTE AND REGULATIONS INVOLVED

The pertinent provisions of the Internal Revenue Code of 1939 and Treasury Regulations are set forth in the Appendix *infra*, pp. 59-63. They are as follows: Sections 22 (a), 112 (a) and (b) (1), 117 (a) (1) and (4), (b), and (j) (1) and (2) of the 1939 Code and Sections 29.112 (a)-1 and 29.112 (b) (1)-1 of Treasury Regulations 111.

QUESTIONS PRESENTED

In each of the five cases, the taxpayer received a lump sum consideration for assignment of a so-called oil payment right (or sulphur payment right) carved out by the taxpayer from a larger mineral interest producing income taxable as ordinary income (subject to a depletion deduction). The principal question presented is whether the consideration received for the assignment is taxable as ordinary income (subject to a depletion deduction), as the Government contends, or as capital gain under Section 117 of the Internal Revenue Code of 1939, as the court below held.

The *Fleming* case also presents the following preliminary question: whether the exchange of an oil payment right for a fee simple interest in real estate

constitutes a tax-free exchange of property of like kind within the meaning of Section 112 (b) (1) of the 1939 Code.

STATEMENT

The *Lake*, *Fleming*, *Wrather*, and *Weed* cases involve income tax deficiencies and originated in the Tax Court. The *O'Connor* case is a suit for refund of income taxes filed in a district court pursuant to 28 U. S. C., Section 1340. In all five cases, the controversy is with respect to the proper treatment, for income tax purposes, of assignments or exchanges of oil (or sulphur) payment rights.[1]

The trial courts, following the lead of the court below in *Caldwell* v. *Campbell*, 218 F. 2d 567 (C. A. 5th), held that the transactions constitute sales, and in the *Fleming* case exchanges, of a capital asset within the meaning of Section 117 of the Internal Revenue Code of 1939 rather than, as the Government contended, assignments of future income. (R. 13–14, 77–78, 153, 155, 212–213, 258–261.) On this issue, in all five cases, the court below affirmed the decisions of the trial courts (R. 16–27, 80–86, 187, 237–238, 262–264.) In the *Fleming* case, the court also held, disagreeing with the Tax Court on a preliminary issue,

[1] Although the language used in the instrument of transfer may vary, an "oil payment" or "oil payment right" is merely a right to receive a specified sum of money (or barrels of oil) payable out of a stipulated portion of oil or oil proceeds if, as, and when the oil is produced. *Anderson* v. *Helvering*, 310 U. S. 404, 410. The right is free and clear of all costs and expenses of production and in that respect is similar to a royalty interest which is, however, "a right to receive a specified percentage of all oil and gas produced during the term of the lease". *Id.*, p. 409.

that exchanges of oil payment rights for real estate were tax-free under Section 112 (b) (1). (R. 180–187.)

The following is a summary of the basic facts in each case:

Lake case

The facts in this case were all stipulated. (R. 7–12, 14.)

P. G. Lake, Inc. (hereinafter called the taxpayer) is a Delaware corporation with its principal office in Tyler, Texas. It is engaged in the business of producing oil and gas. Its properties included the ⅞ working interest[1] in two commercial oil and gas leases, the Reid and Owens Leases, from which it, as the operator, was producing oil in substantial quantities on December 29, 1950. (R. 7–8.)

On that date, being indebted to its president, P. G. Lake, in the sum of $600,000, taxpayer, in consideration of the cancellation of that indebtedness, assigned an oil payment right (see R. 8–10) to its president in the amount of $600,000 plus an amount equal to interest at 3 percent per annum on the unpaid balance remaining from month to month, payable out of 25 percent of the oil attributable to taxpayer's working interest in the Reid and Owens Leases.[2] On the date

[1] The "working interest" is the name commonly given to the leasehold interest and is the entire mineral interest less the royalty interest, usually ⅛, customarily retained by the lessor. See Breeding and Burton, *Taxation of Oil and Gas Income*, Sec. 2.01 (1954); Welsch, *Tax Aspects of Owning and Disposing of Interests in Oil and Gas*, 38 Taxes, Tax Magazine 855 (1953).

[2] The oil payment assignment took the form of a conveyance of "such an interest" in the oil and gas leases "so that" the

of the assignment, it could have been estimated with reasonable accuracy that the assigned oil payment right would pay out in 3 or more years. The actual pay-out period was from January 1951 to February 1954, slightly more than 3 years. (R. 8–11.)

In its 1950 income tax returns, taxpayer reported the oil payment assignment as a sale of property producing a profit of $600,000 taxable as long-term capital gain under Section 117. The deficiency involved in the case results from the Commissioner's determination that the $600,000 (less $660 representing the cost of documentary stamps) is taxable as ordinary income subject to depletion instead of being entitled to preferential tax treatment as capital gain. (R. 11.)

O'Connor case

The facts are reflected in a stipulation of facts (R. 47–50) and the testimony of two witnesses for the taxpayers (R. 57–72). The District Court's findings of fact are contained in the record at pages 74–77.

Here the so-called sale of an oil payment right, consisting of an oil payment assignment for a consideration, was made by the executors, heirs, and devisees of the estate of Thomas O'Connor for the purpose of raising money to pay federal estate taxes, state in-

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assignee "shall own" 25 percent "of all oil and gas in, under or upon such leases and each of them, and shall be entitled to receive" 25 percent of 7/8ths of all the oil, gas, and other minerals "produced, saved and marketed" from the leases "until" the grantee "shall have received by virtue of this interest the sum of" $600,000 plus 3 percent interest (R. 9), at which time the assigned "interest" was to "revert to and revest" in the grantor (R. 10).

heritance taxes, and administration expenses. (R. 47, 76.) In the fiduciary income tax return filed on behalf of the estate for the fiscal period ended November 30, 1948, the proceeds received for the oil payment assignment were reported as ordinary income subject to depletion, but claims for refund were subsequently filed on the ground that the proceeds should have been reported as capital gain. The claims for refund were denied, and this suit for refund followed. (R. 76-77.)

The oil payment assigned by the estate (Ex. B, R. 38-42) on November 26, 1948, was payable out of the income from eight oil royalty interests which the decedent, who died in 1946, had received in 1931 in executing oil and gas leases on property owned by him. (R. 61-62.) The assignment was made to D. L. Blackburn, the president of a bank whose stock was in part (12%) owned by the O'Connors (R. 69), and was in the amount of $10,000,000 plus an amount equal to 4 percent interest per annum on the unrealized balance thereof remaining from month to month, payable out of the oil proceeds from the estate's eight royalty interests.* For the oil payment assignment, Blackburn paid the estate $9,990,350 ($9,650 less than $10,000,000), which he borrowed from the Chase National Bank in New York on his personal 36-month note, bearing 3½ percent interest, without any security other than a deed of trust on the oil payment right he received from the estate. (R. 48, 68, 70.) Before

*The oil payment assignment (Ex. B, R. 38-42) took the form of conveyances of the royalty interests subject to reversion to the assignors when Blackburn had received the specified total amount of money.

making the loan, the Chase National Bank in New York sent its own engineers down to Texas to value the properties and received their approval of the collateral (the oil payment right). (R. 70-71.)

On the date of the oil payment assignment, it could be estimated from available information that pay-out of the assignment would require about 4,000,000 (or about 17 percent) of the remaining 23,150,000 barrels of oil in place attributable to the royalty interests. The assignment paid out in three years. (R. 49-50.)

Fleming case

The facts were all stipulated. (R. 143, 159-179.) In this case, the oil payment assignments were made for real estate rather than for cash. In their income tax returns, taxpayers treated the transactions as tax free exchanges of property of like kind under Section 112 (b) (1) of the 1939 Code, reporting no income at all from the transactions. (R. 164, 166.) The Commissioner determined deficiencies on the ground that the exchanges were not tax free and that the income therefrom, measured by the fair market value of the property, was taxable as ordinary income subject to depletion. (R. 164-165, 166.) The Tax Court agreed with the Commissioner that the transactions were not exchanges of property of like kind so as to be tax free under Section 112 (b) (1), but held, as contended by the taxpayers, that the income from the transactions was taxable as capital gain rather than as ordinary income subject to depletion. (R. 149-155.) On cross-appeals to the Fifth Circuit,

that court held that the transactions were not taxable at all under Section 112 (b) (1) but that, if such a view is erroneous, the income from the transactions is taxable as capital gain under Section 117 of the 1939 Code. (R. 180-187, 189.)

Two so-called exchanges are involved. The first one (see R. 161-162) was made on May 19, 1948, and consisted of separate oil payment assignments by three related parties—Wm. Fleming individually, a partnership in which he and a trust were the partners (R. 161), and the trust—for undivided fee simple interests in a ranch. Four oil payment assignments (Exs. A, B, C, and D; R. 167-177) were made, one by Fleming individually, one by the partnership, and two by the trust. Three were made by the assignors as "owners of leasehold interests" and the other as owner of a royalty interest. The leasehold and royalty interests involved were held by the assignors for productive use in their respective businesses of produc-

The oil payment assignments by the assignors as leasehold owners each took the form of a conveyance of a mineral interest "carved" out of the grantors' interest. Each was described as a specified interest "in and to all the oil in, under, and that may be produced, saved and marketed" under the leases "until" the grantee "shall have received therefrom oil of the net value of" the specified sum of money plus interest, at which time the conveyed "interest" was to "cease and terminate" and "revert to" the grantor. (Ex. A, R. 168, 169; Ex. B, R. 171, 172; Ex. C, R. 173, 174.) The oil payment assignment made by the trust as the owner of a royalty interest was in similar form, except that it purported to be a conveyance of a terminable "undivided 92.3565 /100ths royalty interest" (Ex. D, R. 175), which was stated to cover "92.3565 /100ths of the 1/8th royalty" on oil to be paid under the terms of a lease (R. 175-176).

ing oil. (R. 162.)[1] As to each assignor, the oil payment assignment or assignments (Exs. A, B, C, and D, R. 167–177) was in an amount which represented the uncontested fair market value of the undivided interest in the ranch received by such assignor (see R. 164–165) plus an amount equal to a specified percentage of interest per annum on the balance thereof remaining unpaid from time to time.

The other so-called exchange (see R. 165–166) was made on October 5, 1949, and consisted of an oil payment assignment by taxpayer F. Howard Walsh, as the owner of oil and gas leasehold interests held by him for productive use in his business of producing oil, for the fee simple title to business real estate in Fort Worth, Texas. This oil payment assignment (Ex. E, R. 177–179), like the others, was in the amount of the uncontested fair market value of the real estate received (see R. 166) plus interest on the

[1] It is stipulated that the interests were held for productive use in the assignors' "respective trades and businesses." It is also stipulated that the partnership business was primarily that of producing oil. (R. 161.) That Fleming individually and the trust were in the business of producing oil is alleged and admitted in the pleadings. (See pars. 5 (b) of petition and answer, R. 91–92, 133; pars. 5 (g) of petition and answer, R. 119, 139.)

unpaid balance thereof remaining unpaid from time to time.

The following tabulation shows the pertinent facts as to each of the oil payment assignments involved in the two so-called exchanges:

By William Fleming individually:

Amount	$73,500 "plus an amount equal to" 5 per cent per annum "on the portions of said $73,500 which may be unsatisfied from time to time" (R. 171)
Consideration received	$73,500 (uncontested fair market value of undivided 25 per cent interest in ranch, R. 165)
Payable out of 40 per cent of assignor's share of oil under leasehold interest. (This is not shown in the oil payment assignment, which merely states that the assignor owned "an undivided interest" in certain leases (Ex. B, R. 170), but the assignment purported to convey a terminable .195668 interest in oil and it was alleged in the complaint (par. 5 (h), R. 92) and admitted in the answer (par. 5 (h), R. 133) that the assignor owned a 41.667 working interest in the leases.)	
Estimated pay-out period (As asserted by taxpayers in the court below, based on the annual amounts received by the assignee as shown in the stipulation of facts)	10 to 12 years for the $73,500 *plus interest*

By the partnership:

Amount	$147,000 "plus an amount equal to" 5 per cent interest per annum "on the portions of said $147,000.00 which may be unsatisfied from time to time" (R. 168)
Consideration received	$147,000 (uncontested fair market value of undivided 50 per cent interest in ranch, R. 165)
Payable out of all but approximately 5½ per cent of the assignor's share of oil under leasehold interest (9/13ths of the oil, payable out of assignor's ⅓ of ⅞, 167, 168).	
Estimated pay-out period	5 years and 8 months for the $147,000 *plus interest*

Wrather case

The basic facts were all stipulated (see R. 207-210, 214-236), although there is some pertinent testimony (see R. 206-207).

By the trust:

(1) Amount	$89,000 "plus an amount equal to" 5 per cent interest per annum "on the portions of said $89,000.00 which may be unsatisfied from time to time" (R. 173)
Payable out of 6/64th of 7/8ths of oil (R. 173) (Extent of assignor's leasehold interest not shown)	
Estimated pay-out period	7 to 8 years for the $89,000 *plus interest*
(2) Amount	$24,500 "plus an amount equal to" 5 per cent interest per annum "on the portions of said $24,500.00 which may be unsatisfied from time to time" (R. 176)
Payable out of 32.3235 1000ths of assignor's 1/8th royalty interest (R. 175-176), or about 8 per cent of assignor's interest.	
Estimated pay-out period	7 to 8 years for the $24,500 *plus interest*
Total amount of the two assignments	$73,500 plus an amount equal to 5 per cent interest
Total consideration received	$73,500 (uncontested fair market value of undivided 25 per cent interest in ranch, R. 165)

By Walsh:

Amount	$65,000 "plus interest at the rate of seven (7) per cent per annum on the balances unpaid from time to time" (R. 179)
Consideration received	$65,000 (uncontested fair market value of real estate, R. 166)
Payable out of 1/4 of 7/8 of oil as to all leases except Killough Lease and out of 1/4 of 7/16 as to Killough Lease (R. 178) (Apparently payable out of 1/4 of assignor's interest, since the assignment states that the assignor owned "all or an undivided interest in the oil and gas leasehold estates" (R. 177).)	
Estimated pay-out period	3 1/2 years

Here, as in the *Lake* and *Fleming* cases, the oil payment assignments were made by a leasehold owner. Taxpayer John Wrather was a member of a partnership which was in the business of both drilling and producing oil (R. 207, 208) and which owned a number of oil and gas leasehold interests, including an undivided 7/24 leasehold, or "working", interest in the Brown Lease on land located in Illinois and an undivided 5/16 leasehold interest on the Kieffer "A" Lease on land located in Indiana (R. 208, 209; Exs. D–4, E–5, F–6, and H–8, R. 214–225, 228–229). Both of these interests were held by the partnership for the development and production of oil and gas. (R. 210.) Both leases were productive and had produced income for the partnership prior to 1948. (R. 208, 209.)

In 1948 the partners, together with their wives, made three so-called sales of oil payment rights to the Indiana Farm Bureau Cooperative Association, Inc. (hereinafter called the Cooperative) with relation to production under the Brown and Kieffer "A" Leases. Even in form, however, the oil payment assignments did not purport to be conveyances of property; they were each made by way of an "Oil Payment Agreement" (see Exs. G–7, I–9, and J–10, R. 225–227, 230–236) under which the partners simply agreed and directed that Cooperative "shall be paid" a stated sum of money "out of the oil produced

and saved", to the extent of a designated portion, until the full specified sum was paid to Cooperative.[5]

In their joint income tax returns for 1948, taxpayers reported taxpayer John Wrather's one-half share of the proceeds received for the oil payment assignments ($143,750) as capital gain. The Commissioner determined that the proceeds are taxable as ordinary income subject to depletion. (See R. 211.)

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[5] The following are the other pertinent facts relating to each oil payment assignment (R. 208-210):

Brown Lease

Date	June 19, 1948
Amount	$130,000
Consideration received	$125,000
Payable out of 9/10 of oil attributable to assignor's leasehold interest (9/10 of 7/24 of 7/8)	
Estimated pay-out period	4 to 6 years
Actual pay-out period	4 years

Kuffel "C" Lease

(1) Date	June 19, 1948
Amount	$155,000
Payable out of 9/10 of oil attributable to assignor's leasehold interest (9/10 of 5/16 of 7/8)	
(2) Date	August 16, 1948
Amount	$12,500
Payable out of 9/10 of oil attributable to assignor's leasehold interest (9/10 of 5/16 of 7/8)	
Total amount of the two assignments	$167,500
Total consideration received	$162,500
Estimated pay-out period for both assignments	4 to 6 years
Actual pay-out period for both assignments	5 years and 5 months from first assignment

Wood case

The facts as found by the Tax Court (R. 253-258), based on testimony and exhibits (unprinted), may be summarized as follows:

Here the so-called sale was of a sulphur, instead of an oil, payment right. The taxpayer was the owner of a pooled overriding royalty interest in sulphur produced by the Texas Gulf Sulphur Company from a tract of land, referred to as Boling Dome, in Wharton County, Texas.[2] The royalty interest entitled taxpayer to receive $0.00966133 per long ton of sulphur produced from Boling Dome by the company, irrespective of what the market price for such sulphur might be. Royalty payments were made by the company monthly, based on the previous month's production. (R. 254.)

In the summer or early fall of 1947, taxpayer and two certified public accountants, Marion Munro who was retained by two of taxpayer's corporations and Frank C. Taylor who was retained as accountant for taxpayer's personal affairs, discussed taxpayer's business commitments and the need for providing some sure source of funds for payment of taxpayer's indi-

[2] The Boling Dome tract was composed of a number of parcels of land. The owners of the royalty interests in sulphur produced from each of those individual parcels entered into a pooling agreement pursuant to which royalties from sulphur produced anywhere in Boling Dome were to be distributed pro rata among all such royalty interest holders. Taxpayer's interest is thus referred to as "pooled". (R. 254.)

vidual income taxes, especially those due in January 1948. It was suggested that taxpayer might sell a portion of his Boling Dome royalty interest, and Munro expressed the opinion that such a transaction would have the advantage of being taxed at capital gain rates. Munro also indicated a probable willingness to purchase a portion of the royalty interest. Due consideration was given to the possible tax savings to taxpayer and to the annual royalty payments which Munro would probably receive. As a result, taxpayer and Munro agreed upon a sulphur payment assignment based upon taxpayer's anticipated requirements for funds to pay taxes for the succeeding three years and upon a four-year pay-out period to Munro from sulphur production. Munro advised taxpayer that the latter's tax saving from the transaction would be about $4,000 to $4,500, and Munro estimated that his own profit from the transaction, allowing for interest payable on a loan necessary to make the purchase, would approach $2,000. (R. 255–256.)

As a result, on December 24, 1947, taxpayer assigned to Munro a sulphur payment (Ex. C, R. 248–250) totaling $50,000 and consisting of 86.254514 percent of his pooled royalty interest (*i. e.*, $0.00833333) per long ton on 6,000,000 long tons of the remaining 21,000,000 long tons of sulphur to be produced from Boling Dome.[10] For the sulphur payment assignment,

[10] The Tax Court found as a fact that the estimated number of tons of sulphur still in place was 45,000,000 tons (R. 255), but that finding was based on testimony of taxpayer which, according to an affidavit he filed in the Court of Appeals, should be interpreted as meaning that 45,000,000 tons was the

Munro gave taxpayer—

Check dated 12/24/47	$13,900
Promissory note due 12/24/48 (with 6% annual interest after maturity)	16,300
Promissory note due 12/24/49 (with 6% annual interest after maturity)	16,300
	$46,500

The purchase money, including payment of the notes shortly before their due dates, was borrowed by Munro from a bank with the sulphur payment assignment as security, except that the amount of royalties Munro received prior to the due dates of the notes made it unnecessary for him to borrow more than $11,500 to pay the notes. The assigned sulphur payment right paid out in 28 months. (R. 256–257.)

The case involves only the taxable years 1948 and 1949, the years in which the note payments were received by taxpayer as part of the proceeds from the sulphur payment assignment. The $16,300 received in each of those years was reported by taxpayer as capital gain, and the Commissioner determined that it was taxable as ordinary income subject to depletion. (R. 257–258.)

SUMMARY OF ARGUMENT

I

The inquiry here is whether each of the assignments in these cases was a "sale" or "exchange" of "property" constituting a "capital asset" within the meaning of Section 117 of the Internal Revenue Code of 1939.

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original estimated tonnage—that the *remaining* tonnage at the time of the assignment was 21,000,000 tons.

A. This Court's decisions have established that Section 117 must be interpreted and applied consistently with the congressional purpose to accord preferential tax treatment only to a capital gain, meaning the gain derived from the conversion (or "realization") of the increase in the value of capital investment property. A so-called sale or exchange does not result in capital gain if it is an assignment of future income—a transaction where the "property" sold or exchanged consists only of a right to receive future ordinary income, and where the conversion is not of the increase in the value of capital investment property, but rather of future ordinary income into present income. In such a case, the proceeds of the sale are to be treated for federal tax purposes as a substitute for, and as having the same character as, the future ordinary income which the transferor would himself have received but for the transfer of the right to receive it.

B. Each of the oil payment assignments in the *Lake, O'Connor, Fleming*, and *Wrather* cases, made by the taxpayers as the owners of leasehold or royalty interests, conveyed to the assignee the right to receive a specified portion of the assignor's future oil proceeds. In *Wood*, where the assignment was of a sulphur rather than of an oil payment right and made by the owner of a pooled sulphur royalty interest, the conveyance was of a right to receive a specified dollar amount on a specified number of tons of the future sulphur production. The oil and sulphur payment assignments were all assignments of future income, rather than sales or exchanges of property within the meaning of Section 117, for several reasons.

1. The proceeds received from the production and sale of oil are taxable as ordinary income subject to a depletion allowance. Taxpayers' income-producing, or capital investment, property consisted of leasehold and royalty interests. Since they assigned oil payment rights, their assignments were not of any portion of their oil interests as such and the assignments were unaccompanied by any assignment of taxpayers' income-producing, or capital investment, property. Under the decisions of this Court, the so-called sales were therefore merely assignments of future income.

It is immaterial that oil payment assignments may be recognized as sales of property for some purposes under local law. For tax purposes, transfers of oil interests are treated according to their effect in relation to economic ownership of the oil in place, and it is the oil in place in which a leasehold or royalty owner is deemed to have his capital investment. Oil payment assignments by leasehold and royalty owners do not convey economic ownership of any portion of the oil in place. Taxpayers' oil payment assignments merely created a contractual right to collect a portion of taxpayers' future oil proceeds and, as such, the oil payment assignments were clearly assignments of future income.

2. Assuming that the oil payment assignments constituted transfers of oil (that is, of a portion of taxpayers' economic ownership thereof), the assignments are still assignments of future income. The decisions of this Court establish not only that the proceeds received from the current production of oil are taxable as ordinary income subject to the depletion allowance

but that, when the transferor creates and retains an economic interest in the oil in place on the execution or so-called sale of a lease, the lump sum consideration (or lease bonus) received by the transferor is an advance payment for oil to be produced and is taxable as ordinary income subject to depletion, just as are the future payments from production under the retained interest. Full recognition is given to the transfer of economic ownership of oil in place but no sale occurs for tax purposes when the transferor retains a different economic interest instead of transferring his entire interest (or a fractional part thereof) as such. The so-called sale is merely of oil, and oil is not a capital asset under Section 117. Similarly, a leasehold or royalty owner who assigns an oil payment retains an economic interest in the oil in place and his assignment, assuming that it transfers ownership to a portion of the oil in place, is of property which is not a capital asset. The consideration received for the oil payment assignment is payment in advance for oil to be produced and, as in the case of a lease bonus, is taxable as ordinary income subject to depletion.

The logic of the lease transfer cases is clear. Oil proceeds, whether received in anticipation of production or as the oil is produced, are subject to a depletion deduction which is designed to compensate for the transferor's loss of capital investment to the extent of the transfer. The oil accordingly represents only ordinary income. The lump sum received for its transfer in anticipation of production is a substitute for and has the same character (that of ordinary income subject to depletion) as the future oil

proceeds which the transferor would have received in the future but for his assignment of the right to collect such proceeds. Necessarily, therefore, oil payment assignments by leasehold and royalty owners are assignments of future income even if they effect a transfer of oil.

3. Finally, taxpayers' oil and sulphur payment assignments were but assignments of future income even when considered without reference to the depletion deduction or to the decisions of this Court involving transfers of oil and gas leases. Assuming that the oil and sulphur payment assignments carried with them an interest of some sort in taxpayers' capital investment property, the assignments must still be viewed in the light of realities and practical considerations, rather than according to the "attenuated subtleties" of property law. They were primarily of future income and, as transfers of taxpayers' capital investment property, too temporary and insubstantial to be treated as sales of property within the meaning of Section 117.

Viewed realistically, taxpayers' oil and sulphur payment assignments resulted only in a conversion of future income into present income, rather than in a conversion of the increase in the value of their capital investment property. Taxpayers are seeking preferential tax treatment for transactions which are merely a means of anticipatorily realizing future ordinary income from property of a type for which a special means of recovering the capital investment therein, the depletion deduction, has been provided and is avail-

able in respect of the consideration received for the transfers made by these taxpayers.

II

For several reasons, the so-called exchanges of oil payment rights for fee simple interests in real estate involved in the *Fleming* case were not tax-free exchanges of property of like kind within the meaning of Section 112 (b) (1). First, the transfers were assignments of future income, rather than exchanges of property. Secondly, they did not transfer "property held for productive use in trade or business", as required by Section 112 (b) (1); and, even if it could be said that they transferred oil, such a transfer would be expressly excluded from the operation of the section as being "property held primarily for sale" by taxpayers. And thirdly, the transfers were not of property "of a like kind" to real estate.

ARGUMENT

I

THE LUMP SUM CONSIDERATION RECEIVED BY TAXPAYERS FOR THEIR OIL (OR SULPHUR) PAYMENT ASSIGNMENTS IS TAXABLE AS ORDINARY INCOME SUBJECT TO DEPLETION, RATHER THAN AS CAPITAL GAIN UNDER 1939 CODE SECTION 117

In all five cases, the taxpayers received cash (or real estate in *Fleming*) as a present consideration for oil payment assignments (or, in *Weed*, for a sulphur payment assignment). The proceeds were received without restriction by taxpayers who report their income on the cash basis and are therefore clearly

taxable in the year or years of receipt (the taxable year or years involved in each case).[11]

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[11] *Healy* v. *Commissioner*, 345 U. S. 278, 281. As to a taxpayer on the cash basis, income received under a claim of right and without restriction as to its disposition is taxable in the year of receipt even though it may be claimed that the taxpayer is not entitled to retain the money and even though, as is not the case here, he may subsequently have to refund its equivalent. See *Healy* v. *Commissioner*, *supra*; *United States* v. *Lewis*, 340 U. S. 590; *North American Oil* v. *Burnet*, 286 U. S. 417. This is what is usually called the "claim of right" doctrine. Cf. *Automobile Club* v. *Commissioner*, 353 U. S. 180, 188–189.

In *Commissioner* v. *Slagter*, 238 F. 2d 901, where the Seventh Circuit, unlike the court below, held that an oil payment assignment for a consideration was an assignment of future income rather than a sale of property within the meaning of Section 117, the court seems to have treated the proceeds of the assignment as a loan to the taxpayers. In any event, the court concluded its opinion with a statement (p. 905) to the effect that the oil payments as such were taxable to the taxpayer-assignors as and when subsequently accumulated and paid to the assignee. That is the rule in respect of donative assignments of income, where the donor's realization of income is economic rather than pecuniary. *Helvering* v. *Horst*, 311 U. S. 112. That rule is "founded on administrative convenience" and "is only one of postponement of the tax to the final event of enjoyment of the income." *Id.*, p. 116. In assuming the applicability in *Slagter* of the rule as to when income is taxed in respect of a donative assignment of income, the Seventh Circuit overlooked the fact that the only question in the case, as argued by both parties there as here, was as to *how* the *proceeds* of the oil payment assignment were to be taxed in the *year of receipt*, the only taxable year before the court. When a lump sum consideration is received for an assignment of income, without any obligation of repayment and without any restriction as to use or disposition, it is impossible to ignore the fact that the recipient realizes income immediately upon receipt of the consideration. And see the text, *infra*, pp. 29–30.

The issue here is whether that income is subject to tax at the rates applicable to ordinary income (subject to an allowance for depletion) or at the lower capital gain rates. The court below concluded that the oil payment transactions constituted sales (and, in *Fleming*, exchanges) of property and, accordingly, held the income entitled to the preferential tax treatment accorded to long-term capital gain by Section 117 of the Internal Revenue Code of 1939 (Appendix, *infra*, pp. 60–62).[12] The Government contends that the transactions are not within the purview of Section 117 and that the proceeds are accordingly taxable as ordinary income (subject to an allowance for depletion).

This contention does not, however, rest upon an argument that the transactions could not possibly be characterized as sales and exchanges of property for some purposes under local law unrelated to the federal income tax. As this Court stated in *Burnet* v. *Harmel*, 287 U. S. 103, 110 (a closely related case involving the application of a predecessor of Section 117 to a lump sum bonus received by a landowner on the execution of an oil and gas lease), "we are concerned only with the meaning and application of a [tax] statute enacted by Congress". Accordingly, the question is whether these oil payment transactions are to be treated as sales or exchanges of property within the meaning of Section 117. See *Commissioner* v. *Slaytor*, 238 F. 2d 901 (C. A. 7).

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[12] Under Section 117, only one-half of the amount of long-term capital gain is taxed. See Sections 117 (a) (4) and (b), Appendix, *infra*, pp. 60–61.

A. ASSIGNMENTS OF FUTURE INCOME FOR A CONSIDERATION, WHETHER OR NOT CHARACTERIZED AS SALES OR EXCHANGES FOR SOME LOCAL LAW PURPOSES, DO NOT COME WITHIN SECTION 117

1. The assignment of income rule generally

The "assignment of income" rule, as applied to the future income from property, is that one who retains the income-producing property (or "tree") and transfers what amounts only to a right to receive future income from that property (the "fruit") remains taxable on that income, because in making the transfer he has derived economic benefit which constitutes a realization of the income. In its basic form, the rule is perhaps best illustrated by *Helvering* v. *Horst*, 311 U. S. 112, where a father, who owned a bond, made a gift of one of the interest coupons to his son and was held taxable on the interest as and when collected by the son.

For present purposes, the importance of the assignment of income rule lies, not in when income is taxed thereunder (for that is not in issue here [13]), but in the nature of the income (*i. e.*, ordinary income or capital gain) received by the assignor. Thus, in the *Horst* case, *supra*, both the bond retained by the father and the interest coupon which he gave to his son constituted "property", but one type (the interest coupon) amounted only to a right to receive future income from the income-producing property (the bond), and therefore the transfer of this right, even though under state law it be regarded as a "property"

[13] See note 11, *supra*.

right, was considered not a transfer of property under Section 117 but an assignment of future income. There, of course, the income "property" was separable from the income-producing (or capital investment) property. But the rule has also been applied where, although there was a transfer of the income-producing (or capital investment) property itself, the transfer was only temporary or insubstantial. (See *infra*, pp. 48–50.)

In short, an "assignment of future income", or "anticipatory assignment of income", is a transfer of something which, although perhaps in some respects treated by local law as "property" or a "property" right, represents essentially only a right to receive future income, when considered from the standpoint of practicalities and in the light of what the transferor had, retained, and assigned. It stands in direct contrast with a transfer of the income-producing property in which the taxpayer has his capital investment—and it is only the latter type of transfer which, when made for a consideration, is entitled to the capital-gain benefits conferred by Section 117.

2. Assignments of future income for a consideration as related to the scope of Section 117

Section 117 applies to the "sale" or "exchange" of "property" falling within the category of "*capital assets*". Not all sales and exchanges of property are sales or exchanges of capital assets. Some are specifically excluded by the definition of "capital assets" contained in Section 117 (a) (1), such as sales of stock in trade and of property held primarily for sale

to customers in the ordinary course of business. In addition, the statute must be interpreted and applied so as to effectuate the manifest purpose of Congress (*Corn Products Co.* v. *Commissioner*, 350 U. S. 46, 52; see also *Burnet* v. *Harmel*, 287 U. S. 103); the statutory language is not to be interpreted literally or according to its usual meaning when to do so would thwart that purpose (*Helvering* v. *Hammel*, 311 U. S. 504, 510–511). Even true sales which "do not come within the literal language of the exclusions set out in that section" (*Corn Products Co.* v. *Commissioner*, *supra*, p. 51) are excluded from its operation when they do not fall within its intended coverage. That is forcefully illustrated by the *Corn Products Co.* case, *supra*, where, under the circumstances involved, sales of corn futures were excluded from Section 117 because they constituted a normal source of business income.

As the Court stated in the *Corn Products Co.* case, *supra*, p. 52, Section 117 "was intended 'to relieve the taxpayer from . . . . excessive tax burdens on gains resulting from a *conversion of capital investments*, and to remove the deterrent effect of those burdens on such conversions.' *Burnet* v. *Harmel*, 287 U. S., at 106." (Italics supplied.) Thus, the sole purpose of Section 117 is to accord preferential tax treatment, by way of relief from otherwise excessive tax burdens, to the gain derived, through a sale or exchange, from an increase in the value of property in which the taxpayer has a capital investment. That

of course is also implicit in the fact that, by its terms, Section 117 applies to *capital* gain derived from sales and exchanges of *capital* assets."[14] See *United States* v. *Snow*, 223 F. 2d 103, 108 (C. A. 9th), certiorari denied, 350 U. S. 831. It necessarily follows, therefore, that Section 117 is inapplicable to an assignment of future income for a consideration, or to a so-called sale of property of a type which for all practical purposes amounts only to a right to receive future income.

An anticipatory assignment of income for a consideration is also not a "sale" or "exchange" within the meaning of Section 117. It operates only as a transfer of future *income* and does not even satisfy the literal requirement of Section 117 that there be a "sale" or "exchange" of property. But, in any event, to be a sale or exchange producing capital gain within the meaning of Section 117, a transfer must effect a conversion of the increase in value of a capital asset into realized gain. No such conversion is effected by an assignment of future income for a con-

[14] Subsection (j), which was added to Section 117 by Section 151 (b) of the Revenue Act of 1942, c. 619, 56 Stat. 798, accords capital gain treatment to "property used in the trade or business", defined, so far as pertinent here, as including "real property used in the trade or business, held for more than 6 months, which is not * * * (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." This subsection was added simultaneously with an amendment which excluded "real property used in the trade or business of the taxpayer" (see Section 151 (a) of the 1942 Act, *supra*) from the definition of "capital assets" contained in Section 117 (a) (1) and represents no change in the purpose of Section 117, at least so far as pertinent here.

sideration. The conversion is, not of any increase in the value of the capital asset, but merely of *future* income into *present* income; the transferor merely obtains the present value of the income which he would otherwise receive in the future." To treat such assignments of income for a consideration as sales or exchanges of property under Section 117 would distort the basic distinction between ordinary income and capital gains, and would result in a tax windfall to taxpayers who would otherwise pay tax at the higher rates paid by all other taxpayers receiving similar income.

Accordingly, in a variety of situations, the Courts of Appeals have held the benefits of Section 117 inapplicable to sales which were in substance only assignments of future income, holding that the consideration received therefor is taxable as ordinary income rather than as capital gain. See *Helvering* v. *Smith*, 90 F. 2d 590 (C. A. 2d) (lump sum received for partner's share of accounts receivable of partnership); *Rhodes' Estate* v. *Commissioner*, 131 F. 2d 50 (C. A. 6th) (sale of dividend declared but not yet payable); *Fisher* v. *Commissioner*, 209 F. 2d 513 (C. A. 6th), certiorari denied, 347 U. S. 1014 (sale, along with notes, of right to collect defaulted interest); *United States* v. *Snow*, 223 F. 2d 103 (C. A. 9th), certiorari denied, 350 U. S. 831 (sale, along with partnership interest, of partner's share of accrued but undistributed earnings of partnership); *Doyle* v. *Commissioner*, 102 F. 2d 86 (C. A. 4th) (settlement sum received by partner, on dissolution of partnership, for his proportionate share of uncollected fees of

partnership); *Halbert* v. *Commissioner*, 227 F. 2d 399 (C. A. 7th) (anticipatory transfer of business income of partnership under agreement for future sale of business). As the Second Circuit long ago stated in *Helvering* v. *Smith*, *supra*, p. 592: "The 'purchase' of that future income did not turn it into capital, any more than the discount of a note received in consideration of personal services. The commuted payment merely replaced the future income with cash." In short, in any case where the lump sum consideration is essentially a substitute for what would otherwise be received in the future as ordinary income, the lump sum consideration is taxable as ordinary income even though, in a sense, a transfer of "property" is involved. See cases just cited and *Watson* v. *Commissioner*, 345 U. S. 544; *Hort* v. *Commissioner*, 313 U. S. 28; *United States* v. *Safety Car Heating Co.*, 297 U. S. 88.

This general principle, the validity of which is beyond dispute, is fully applicable to the facts of these cases, as we shall now demonstrate.

B. TAXPAYERS' OIL (OR SULPHUR) PAYMENT ASSIGNMENTS WERE ASSIGNMENTS OF FUTURE INCOME

The taxpayers in four of these cases were the owners of oil and gas leasehold interests (*Lake*, *Fleming*, and *Wrather*) or of oil royalty interests (*O'Connor* and as to one of the assignments in *Fleming*), both of which are depletable interests (*Burnet* v. *Harmel*, 287 U. S. 103; *Anderson* v. *Helvering*, 310 U. S. 404.

408).[15] Those taxpayers each carved out of their larger interests lesser interests called oil payment rights—the right to receive a specified portion of the assignor's future oil proceeds from a stipulated portion of the oil if, as, and when produced (*id.*, p. 410)—and assigned such lesser interests for a consideration. In the *Weed* case, the taxpayer was the owner of a sulphur royalty interest, which is also a depletable interest (see Sections 23 (m) and 114 (b) (4) (iv) of the 1939 Code, 26 U. S. C. 1952 ed., Secs. 23 and 114), and he assigned a sulphur payment right, consisting of the right to receive a stated

[15] The owners of a leasehold interest, which is the "working interest", have control over oil production and liability for all the costs and expenses of operation and production (Breeding and Burton, *Taxation of Oil and Gas Income* (1954), Sec. 2.04) and are the owners of the entire mineral interest less the royalty interest customarily retained by the landowner-lessor or sublessor (*id.*, Secs. 1.07, 2.04, and 3.02; Welsch, *Tax Aspects of Owning and Disposing of Interests in Oil and Gas*, 31 Taxes, Tax Magazine 855 (1953); *Burnet* v. *Harmel*, 287 U. S. 103, 106). The owner of a royalty interest (in the *O'Connor* case, royalty interests which had been retained by a landowner-lessor, see R. 61–62) has "a right to receive a specified percentage of all oil and gas produced during the term of the lease" (*Anderson* v. *Helvering*, 310 U. S. 404, 409), which of course is free and clear of the expenses of operation and production for which the leasehold owners are liable. While the owners of royalty interests do not have the same element of control over oil production as the owners of leasehold interests, they are for all practical purposes the owners of a percentage of all the oil and gas in place.

amount of money per ton on a stated portion of the future sulphur production.[16]

We have already shown (*supra,* pp. 25–30) that assignments of future income for a consideration are excluded from the preferential tax treatment accorded to capital gains by Section 117 for the reason that only transfers for a consideration of the transferor's capital investment property are within the purview of that section. The remaining question is whether, under the circumstances here, taxpayers' oil (or sulphur) payment assignments were assignments of future income. It is submitted that they clearly were. First, they conferred on the assignee only a contractual right to collect future ordinary income which, but for the assignments, would have been collected by the taxpayers. Second, at most, the only thing conveyed was oil, which is not a capital asset under Section 117. Third, the transfers were not sufficiently substantial, in relation to taxpayers' retained oil interests from which the oil payments were carved out, to be treated as sales of the taxpayers' capital investment property.

For brevity, our argument will refer to transfers of oil interests, but the reasoning applies equally to the sulphur payment assignment involved in the *Weed* case, which is separately referred to later (*infra,* fn. 21, pp. 41–42).

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[16] The Commissioner allowed a 23 per cent depletion deduction on the consideration received for the *Weed* sulphur payment assignment. (See R. 245.)

1. Taxpayers' assignments conferred only a contractual right to collect future income of the taxpayers

There are three possible types of "property" which might be conveyed by an oil payment assignment carved out of a retained interest: (1) an undivided portion of the transferor's oil interest as such; (2) oil; or (3) a mere contractual right to receive a specified amount of the proceeds of future oil production. Obviously, taxpayers' oil payment assignments did not convey (1) an undivided portion of the taxpayers' oil interests as such. Taxpayers were the owners of leasehold and royalty interests and they conveyed only oil payment rights. It is therefore clear that a different type of property was transferred—*i. e.*, either (2) oil or (3) a mere contractual right to receive a specified amount of the proceeds of future oil production.

In either event, we contend, there was no sale of a capital asset for the purposes of Section 117. In this section of the brief, we shall show that an oil payment assignment carved out of a larger interest (such as a leasehold or royalty interest) does not convey oil; it merely confers on the assignee a contractual right to receive future proceeds from the sale of oil.

(*a.*) Taxpayers' "tree," their income-producing or investment property, consisted of their leasehold and royalty interests. The oil production business "is said to resemble a manufacturing business carried on by the use of the soil" (*Anderson* v. *Helvering*, 310 U. S. 404, 407–408) "to which the passing of title of the minerals is but an incident" (*Burnet* v. *Harmel*, 287 U. S. 103, 107). The proceeds received by taxpayers from the production and sale of oil are all taxable to

them as ordinary income (*Burnet* v. *Harmel*, *supra*) except for the amount of their depletion deduction, which represents a tax-free return of their capital investment in the leases (see *Anderson* v. *Helvering*, *supra*, p. 408).

Taxpayers' oil payment assignments, unaccompanied by any assignment of the income producing, or capital investment, property which would produce the income, were anticipatory assignments of income of the most fundamental sort, no different from any other assignment of the future income without a proportionate transfer of ownership of the income-producing property. The consideration taxpayers received for their oil payment assignments was a substitute for the future income they would otherwise have received and accordingly has the same character, *i. e.*, ordinary income (subject to depletion).

The very nature of each transaction involved here precludes any other conclusion. Indeed, the parties themselves quite clearly treated the assignments as conveying only a right to future cash payments rather than an investment in oil.

In the *Lake* case, the taxpayer-corporation owed its president $600,000 and, in consideration of the cancellation of the indebtedness, made an oil payment assignment to him in the amount of $600,000 plus an amount equal to 3 per cent interest per annum on the unpaid balance of the $600,000 remaining from month to month. (See Statement, *supra*, p. 5.) Plainly, the oil payment assignment, although it had a relation to unproduced oil, amounted only to payment of an indebtedness, plus interest thereon, with a "property" right which had a market value

and was transferable but which, from a practical standpoint, represented only an anticipatory assignment of a portion of the debtor's future, assured cash income.

In the *O'Connor* case (see Statement, *supra*, pp. 7–8), a sale resulted only because the assignors used an intermediary to obtain $9,990,350 on a loan from the Chase National Bank in New York with the assigned oil payment right as the sole security. There was no real sale of oil or of an oil interest at a discount price, for the purchaser paid only $9,650 less than $10,000,000 for an oil payment right which paid out in three years and was in the amount of $10,000,000 plus 4 per cent interest thereon, 3½ per cent of which the purchaser in turn paid on the loan of the purchase price from the Chase National Bank in New York. The purchaser made a profit of $110,000 (R. 69), as he had expected (R. 70), on a $10,000,000 transaction which cost him nothing but by virtue of which the assignors seek a refund of over $3,000,000 in taxes.

In the *Fleming* case (see Statement, *supra*, pp. 9–11), the oil payment assignments were each in the exact amount of the fair market value of the real estate received by the assignor plus, in each instance, an amount equal to interest of a stated percentage on the unpaid balance remaining unpaid from time to time. Here, the taxpayers simply used portions of their future oil proceeds to purchase real estate, paying interest on the unpaid portion of the purchase price. The transactions were, in substance,

no different from the execution of a secured promissory note in the amount of the purchase price.

In the *Wrather* case, where three oil payment assignments were made at a flat discount, the oil payment assignments did not even purport to convey anything other than the right to receive *cash* from oil produced. Similarly, in the *Weed* case, it was the right to receive cash which was assigned. (See Statement, *supra*, pp. 13–14, 16.)

Furthermore, any doubt as to the true nature of these transactions should be resolved against the taxpayers. As already pointed out (*supra*, p. 27), this Court has held that the capital-gains provisions are to be "narrowly applied" so as to effectuate the congressional policy of taxing at ordinary income rates the profits "arising from the everyday operation of a business" while, at the same time, limiting preferential capital-gain treatment "to transactions in property which are not the normal source of business income." *Corn Products Co.* v. *Commissioner*, 350 U. S. 46, 52. And, as the *Corn Products* case demonstrates, a transaction may fit the literal language of the statute and yet not qualify for capital-gain treatment where it does not fall within the obvious purpose of Congress and where a taxpayer would otherwise be able (pp. 53–54) "to transmute ordinary income into capital gain at will." This rationale is even more clearly applicable here, where the "capital" or property transferred consists only of a right to receive future income—income which, if the right to receive it were not thus transferred, would undisputably be taxed as ordinary income. In this crucial respect, the instant cases are

indistinguishable from *Horst* and the other cases discussed in Point A, *supra,* applying the basic assignment-of-future-income rule.

(*b.*) The same conclusion—that is, that taxpayers' oil payment assignments were merely assignments of future income—is reached if the problem is approached in terms of ownership of an "economic interest" in the oil in place, for it is only the transfer of such an interest which will be given effect for tax purposes.

For example, on the execution or so-called sale of a lease, the proper tax treatment to be accorded to a lump sum consideration (as well as the transferor's right to depletion) depends upon whether the transferor has retained an economic interest in the oil in place. See, *e. g., Burnet* v. *Harmel, supra; Thomas* v. *Perkins,* 301 U. S. 655; *Anderson* v. *Helvering,* 310 U. S. 404; *Kirby Petroleum Co.* v. *Commissioner,* 326 U. S. 599; *Burton-Sutton Oil Co.* v. *Commissioner,* 328 U. S. 25. An economic interest in the oil in place may also be acquired as well as retained. *Commissioner* v. *Southwest Expl. Co.,* 350 U. S. 308. Here, however, taxpayers' assignments did not result in the receipt by the assignees of an economic interest,[17] and hence the assignments necessarily did no more than confer contractual rights to receive portions of taxpayers' future income.

[17] It should be noted that, even if the assignments did convey an economic interest in the oil in place, the assignees would be entitled to depletion only on the excess of the oil payments over the amount paid for the assignments.

An "economic interest" in the oil in place is synonymous with a capital investment or a depletable interest (*Burton-Sutton Oil Co.* v. *Commissioner, supra,* p. 32). It encompasses two "interrelated concepts" or "factors"—(1) the acquisition, by investment, of an interest in the oil in place, and (2) a legal relationship which makes the receipt of income from that interest dependent solely upon production. *Commissioner* v. *Southwest Expl. Co., supra,* pp. 313–314. In other words, an "economic interest" means a possibility of profit dependent solely upon the extraction and sale of oil in which the taxpayer has a capital investment. *Kirby Petroleum Co.* v. *Commissioner,* 326 U. S. 599, 603, 604.

The assignment by a leasehold or royalty owner of an oil payment carved out of his retained interest fulfills one of the requirements of an economic (or depletable) interest, since it creates a legal relationship pursuant to which the receipt of income by the assignee is dependent solely upon the production of oil. But, as the Court specifically held in *Commissioner* v. *Southwest Expl. Co., supra,* there must also be a capital investment in the oil in place.[18] The cap-

[18] Even before the *Southwest Expl. Co.* decision, the Court had repeatedly emphasized the necessity of a capital investment in the oil in place. See *Palmer* v. *Bender,* 287 U. S. 551, 557–559; *Murphy Oil Co.* v. *Burnet,* 287 U. S. 299; *Thomas* v. *Perkins,* 301 U. S. 655, 661; *Helvering* v. *Bankline Oil Co.,* 303 U. S. 362, 367, 368; *Helvering* v. *O'Donnell,* 303 U. S. 370, 371; *Helvering* v. *Elbe Oil Land Co.,* 303 U. S. 372, 375–376; *Anderson* v. *Helvering,* 310 U. S. 404, 407–411; *Kirby Petroleum Co.* v. *Commissioner,* 326 U. S. 599, 603; *Burton-Sutton Oil Co.* v. *Commissioner,* 328 U. S. 25, 32–33.

ital investment must be in the property to be depleted, the oil in place, because the depletion deduction is "based on the theory that the extraction of minerals gradually exhausts the capital investment in the mineral deposit." *Id.*, p. 312. A mere economic advantage from the production of oil is not sufficient. *Helvering* v. *Bankline Oil Co.*, 303 U. S. 362; Treasury Regulations 111, Section 29.23 (m)-1.

Thus, unless the lump sums paid by each of the assignees of taxpayers' oil payment assignments constituted capital investments in the oil in place, the assignees did not acquire economic (or depletable) interests. It is submitted that no such capital investments were made by the assignees here and, accordingly, that taxpayers' oil payment assignments conveyed to the assignees only contractual rights to collect a portion of the assignors' future oil proceeds, instead of conveying portions of taxpayers' economic interests or capital investment properties.[19]

In the lease transfer cases, where the transferor was held to have retained a depletable economic interest, it was because he retained an interest in which he had a capital investment by reason of the fact that the interest related back to a fee or leasehold interest which included the right to exploit the oil property.[20]

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[19] A distinction might be made in an instance where the consideration for an oil payment assignment is, pursuant to contract, required to be used for further development of the property. Such a distinction is immaterial in these cases since no such agreements were entered into nor was the consideration so used. All taxpayers had unlimited use of the sums received for the assignments.

[20] See *Commissioner* v. *Southwest Expl. Co.*, *supra*, pp. 314–315; *Palmer* v. *Bender*, 287 U. S. 551, 558; *Burton-Sutton Oil Co.* v. *Commissioner*, 328 U. S. 25, 33–35.

But the purchaser of a carved out oil payment right does not make a capital investment in the oil in place unless he makes an "indispensable contribution" to oil production (*Commissioner* v. *Southwest Expl. Co., supra,* p. 317). There was no dedication to production of the proceeds from the oil payment assignments in any of these cases or any other contribution to production by the purchasers. Indeed, in each instance here, the parties themselves treated the proceeds from the oil payment assignments as cash rather than as investments in the oil in place. (See *supra,* pp. 34–36.) Here the capital investment by the purchasers was merely in a right to collect, as nominees of the transferors, a stated amount of the taxpayers' future income from the production of oil in which taxpayers continued to have a depletable economic interest. While it is true that the assignee's right is eventually exhausted, that is so because his rights stem from a contract which contains its own dollar limitations and his rights come to an end when the requisite amount of money has been paid. As the Court recognized in *Anderson* v. *Helvering,* 310 U. S. 404, 410: "The value of the right, * * * is fixed at the moment of creation and does not vary directly with the severance of the mineral from the soil. In this sense it resembles the right to cash payments more closely than the right to royalty payments."

Thomas v. *Perkins,* 301 U. S. 655, in which an oil payment right was held to constitute an economic interest, is inapposite here. In that case the oil payment right was *retained* on the assignment of a lease. It was held to constitute an economic interest on the

theory that, as the Court stated in *Anderson* v. *Helvering, supra,* p. 411, "* * *" the provision in the lease for payments solely out of oil production should be regarded as a reservation from the granting clause of an amount of oil sufficient to make the agreed payments, * * *." Thus, *Thomas* v. *Perkins, supra,* is simply an instance where the requisite capital investment in the oil in place was deemed to carry over from exploitation rights under a chain of title stemming from a leasehold interest.

Since taxpayers' oil payment assignments did not convey an economic interest in the oil in place, they necessarily did not constitute transfers of a portion of taxpayers' capital investment property and conferred upon the assignees only a right to collect portions of the taxpayers' future oil proceeds.[21] The five cases vividly portray, we submit, the lack of merit in the holding below that taxpayers' oil payment assignments are to be treated as sales of capital investment property entitled to preferential capital gain treatment under Section 117. Such preferential tax treatment is reserved for gain attributable to the increase in the value of investment property, whereas (as will now be shown in greater detail) so-called sales of oil payment rights by the owners of leasehold and royalty interests are merely a means of anticipatorily realizing future ordinary income from property of a type for which a special means of recovering the capital investment therein, the depletion deduction, has been specifically provided by Congress.

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[21] The above arguments (pp. 33–41) have equal application to the sulphur payment assignment involved in the *Weed* case. Indeed, the law with respect to oil and gas leases evolved from de-

2. At most, the assignments conveyed oil (or sulphur), which is not a capital asset

We have shown (*supra*, pp. 33–41) that taxpayers' assignments conferred only a contractual right to collect future income and did not convey an economic interest in oil. On that basis alone, we believe a reversal of the decisions below is required. In this part of our brief, we shall assume *arguendo* that taxpayers' assignments did convey an interest in oil. Under that approach also, taxpayers' assignments were assignments of future income rather than sales of property within the scope of Section 117.

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cisions of the Court relating to mining leases. See *Burnet* v. *Harmel*, 287 U. S. 103, 107–108; *Palmer* v. *Bender*, 287 U. S. 551, 557; *Anderson* v. *Helvering*, 310 U. S. 404, 407–408. The proceeds of mining, like the proceeds of oil production, are ordinary income, not capital gain from the conversion of the mineral in place. See explanation in *Burnet* v. *Harmel*, *supra*, pp. 107–108. The depletion deduction is similarly allowable as to sulphur mining. See Sections 23 (m) and 114 (b) (4) (iv) of the 1939 Code. Hence, transfers of sulphur interests, like transfers of oil interests, are to be considered from the standpoint of their relation to an income-producing business, rather than as transfers of property. As a matter of fact, the *Weed* sulphur payment assignment did not even purport to convey any property other than the "property" right to receive a specified dollar amount per long ton ($0.00833333) on 6,000,000 of the remaining 21,000,000 long tons of sulphur to be produced from a particular tract by a particular company. (*Statement*, *supra*, p. 16.)

The only major difference between the *Weed* case and the other cases is that the consideration received for the sulphur payment assignment was not all received in the year the sulphur payment assignment was made. The income involved is that received in two subsequent taxable years in payment of unsecured, non-interest bearing notes. (See *Statement*, *supra*, pp. 16–17.) Being on a cash basis, Weed realized income from the sulphur payment assignment only when he received the consideration therefor in money or in notes which, like money, were freely and easily ne-

In *Burnet* v. *Harmel*, 287 U. S. 103, it was decided that oil is *not* a capital asset. That case involved the execution of an oil and gas lease by a landowner for a lump sum consideration (usually called a lease bonus) plus retained royalties from future production. The Court held that, even though the lease under the applicable state law conveyed title to the oil in place, there was not a sale of property for tax purposes. That case clearly stands for the proposition that the consideration received for an assignment of oil is taxable as ordinary income subject to a depletion deduction, and not as capital gain under Section 117. As the Court there stated (p. 107) and later reiterated in *Anderson* v. *Helvering*, 310 U. S. 404, 407–408, oil production is treated as an income-production operation akin to a manufacturing business, rather than as a conversion of a capital asset consisting of oil in place.

The *Harmel* decision also established the principle that, when the transferor creates a type of interest in the production of oil which is different from that retained, a lump sum consideration received on the

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gotiable. *Bedell* v. *Commissioner*, 30 F. 2d 622, 624 (C. A. 2d); *Nitterhouse* v. *Commissioner*, 207 F. 2d 618, 620 (C. A. 3d); *Ennis* v. *Commissioner*, 17 T. C. 465, 470. The notes he received in 1947 were term notes, one for a year and one for two years, which were not secured and which were non-interest bearing until after maturity. They represented only a plain, unsecured promise to pay in the future and quite obviously were not the equivalent of cash. *Bedell* v. *Commissioner*, *supra*; *Nitterhouse* v. *Commissioner*, *supra*; *Humphrey* v. *Commissioner*, 32 B. T. A. 280; cf. *Perry* v. *Commissioner*, 152 F. 2d 183 (C. A. 8th); *Johnston* v. *Commissioner*, 14 T. C. 560. Accordingly, the consideration which the notes represented was realized and received by taxpayer in 1948 and 1949 when the notes were paid.

execution of a lease is taxable as ordinary income (subject to depletion) just as are the future oil proceeds, and not as capital gain. Thus, in *Harmel*, where the consideration for the execution of the lease consisted of cash and a royalty interest created and retained from the lessor's interest, it was held that there was not a sale for tax purposes and accordingly the cash consideration (or lease bonus) received by the transferor was treated in the same manner as the royalties to be received from future production under the retained royalty interest—that is, as ordinary income (subject to depletion) and not as capital gain.

The principles of *Harmel* were subsequently applied to the so-called sale of a lease (usually denominated as a sublease) (*Palmer* v. *Bender*, 287 U. S. 551; *Helvering* v. *Twin Bell Syndicate*, 293 U. S. 312; *Burton-Sutton Oil Co.* v. *Commissioner*, 328 U. S. 25). Moreover, the Court later expressly held (*Kirby Petroleum Co.* v. *Commissioner*, 326 U. S. 599, 603; *Thomas* v. *Perkins*, 301 U. S. 655; *Anderson* v. *Helvering*, *supra*, pp. 409–410) that the lump sum cash consideration is "payment *in advance* for oil and gas to be extracted" (italics supplied) (*Herring* v. *Commissioner*, 293 U. S. 322, 324). In brief, the mere fact that the execution or so-called sale of an oil and gas lease may result in a division in ownership of the oil does not mean that, for tax purposes, the transfer of oil for a consideration (determined according to economic rather than legal ownership; see *supra*, pp. 37–38) constitutes the sale of a capital asset.

The basic principle of the *Harmel* decision is that oil proceeds, whether received in anticipation or as a result of production, are taxable as ordinary income subject to depletion rather than as capital gain. That principle has been recognized and applied in numerous decisions involving other questions relating to the transfer of oil and gas leases. Although recognition is given to the transfer of economic ownership of at least a part of the oil, the creation and retention by the transferor of an oil interest of a type different from that transferred (such as a royalty interest) has been held to preclude a sale for tax purposes and to entitle the transferor to depletion (allowable only on oil proceeds as ordinary income) not just on the future proceeds received under the retained interest but also on the lump sum cash consideration (or lease bonus) (*Palmer* v. *Bender, supra; Kirby Petroleum Co.* v. *Commissioner,* 326 U. S. 599). Similarly, whether the transferee is taxable on the future payments to the transferor as constituting income to the transferee paid by him to the transferor as purchase price depends upon whether the transferor has retained an interest in oil production (as represented by a royalty or other economic interest). *Anderson* v. *Helvering,* 310 U. S. 404, 407; *Thomas* v. *Perkins,* 301 U. S. 655; *Burton-Sutton Oil Co.* v. *Commissioner,* 328 U. S. 25.

Thus, all of the lease transfer cases demonstrate that a mere transfer of oil, as distinguished from a transfer of the transferor's entire interest as such (or a fractional undivided portion thereof), is not a sale for tax purposes. The oil is not a capital asset and the proceeds

received from the sale of oil, in anticipation of production or as produced, are merely a substitute for the proceeds from future production which are taxable as ordinary income subject to depletion.

It therefore follows that the assignment of an oil payment right carved out by the owner of a leasehold or royalty interest, as in the present cases, does not constitute a "sale" of "property" for the purposes of Section 117. Such an assignment cannot possibly transfer any "property" other than oil (or a mere contractual right to the proceeds of future production, see *supra*, pp. 37–41). While the ownership of oil is one of the attributes of a leasehold or royalty interest, a transfer of a part of the oil by way of an oil payment right carved out of a leasehold or royalty interest can no more be treated for tax purposes as the sale of a capital asset than can a transfer of oil under a lease by a leasehold owner who retains some other interest in production, such as a royalty interest.

The reason for the rule of the lease transfer cases, particularly as applied to oil payment assignments by leasehold and royalty owners, is abundantly clear. The capital investment of the owner of a leasehold or royalty interest is deemed to be in the oil in place. *Palmer* v. *Bender*, 287 U. S. 551, 558; *Burton-Sutton Oil Co.* v. *Commissioner*, 328 U. S. 25, 32; *Commissioner* v. *Southwest Expl. Co.*, 350 U. S. 308. A depletion deduction of at least 27½ percent of the

"gross income from the property"[22] (See Sections 23 (m) and 114 (b) (3) (26 U. S. C. 1952 ed., Secs. 23 and 114)), meaning "income from the oil and gas wells on the property" (*Burton-Sutton Oil Co.* v. *Commissioner, supra,* p. 29, fn. 4), has been provided by Congress "to permit a recoupment of the owner's capital investment in the minerals" (*Commissioner* v. *Southwest Expl. Co., supra,* p. 312). See also *Helvering* v. *Bankline Oil Co.,* 303 U. S. 362, 366. The result is that the depletion allowance "is appropriated by the statute to the restoration of the taxpayer's capital and the rest of the proceeds of the natural asset becomes gross income" (*Kirby Petroleum Co.* v. *Commissioner,* 326 U. S. 599, 603). Thus, the lump sum consideration received for an oil payment assignment by the owner of a leasehold or royalty interest represents anticipatory oil proceeds and is for that reason depletable (as in the case of a lease bonus, see *Herring* v. *Commissioner,* 293 U. S. 322; *Douglas* v. *Commissioner,* 322 U. S. 275); and the depletion deduction compensates the transferor for his loss of capital investment to the extent of the transfer. The transfer is of property which wholly represents income, and the oil payment assignment amounts to nothing more than an assign-

[22] Limited to 50 percent of the net income from the property but not limited merely to recoupment of the amount of the capital investment in the property. See *Commissioner* v. *Southwest Expl. Co., supra,* p. 312, fn. 6.

ment of income.[23] Cf. *Commissioner* v. *First State Bank of Stratford*, 168 F. 2d 1004 (C. A. 5th), certiorari denied, 335 U. S. 867; *Richards' Estate* v. *Commissioner*, 150 F. 2d 837 (C. A. 2d); *Doyle* v. *Commissioner*, 147 F. 2d 769 (C. A. 4th).

3. Even if taxpayers' oil (or sulphur) payment assignments could be considered as transferring some portion of their capital investment property, the insubstantiality of the transfers requires that they be treated for federal tax purposes as assignments of future income

As already indicated (*supra*, p. 26), a determination of whether a transfer of property constitutes an assignment of future income, as distinguished from a transfer of the transferor's capital investment prop-

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[23] That the depletion deduction usually covers *more* than a recoupment of the capital investment is shown by the present record. In the *Fleming* case, under the Commissioner's contention that the consideration received for the oil payment assignments is taxable as ordinary income subject to depletion, Wm. Fleming individually receives a depletion deduction of $20,212.50 for an oil payment assignment which had no cost basis (R. 97); taxpayer Walsh similarly receives a depletion deduction of $17,875 for an oil payment assignment which had no cost basis (R. 112, 466); the partnership receives a depletion deduction of $40,425 for an oil payment assignment which had a basis of $1,102.70 (R. 118); and the trust receives a depletion deduction of $20,212.50 for two oil payment assignments which had a basis of $18,119.21 (R. 120). In the *O'Connor* case, where the taxpayers first reported the consideration received for their oil payment assignment as ordinary income and then sued for refund on the ground that the consideration is taxable as capital gain, the depletion deduction is $2,747,346.25 as against a basis of $1,949,183.55 if the consideration is taxed as capital gain. (R. 35, 48.) Although they received almost $1,000,000 more than the basis of the oil payment assignment, the O'Connors are seeking a tax refund of over $3,500,000 plus interest. (R. 33.)

erty, must be made in the light of "practical considerations." *Harrison* v. *Schaffner*, 312 U. S. 579, 582. The anticipatory assignment of income rule is applicable despite a transfer of title to the income-producing (or capital investment) property if, under the facts and circumstances of the transfer, the transferor remains the *real* owner of the income-producing (or capital investment) property.

That principle was first enunciated in *Helvering* v. *Clifford*, 309 U. S. 331, where the grantor of a 5-year trust was held taxable on the trust income paid to his beneficiary-wife because the dilution of his control over the corpus was not substantial. The principle was subsequently applied to the transfer by a trust beneficiary of a portion of his trust interest (*Harrison* v. *Schaffner, supra*), to the creation of long-term trusts (*Helvering* v. *Stuart*, 317 U. S. 154), to the transfer of patents (*Commissioner* v. *Sunnen*, 333 U. S. 591, and to so-called family partnerships (*Commissioner* v. *Culbertson*, 337 U. S. 733). Even when a transfer is both an assignment of a right to receive future income and a transfer of a proportionate part of the income-producing (or capital investment) property, the nature of the transaction is still controlled by realities rather than by the "attenuated subtleties" of the law of property. *Harrison* v. *Schaffner, supra*, p. 581. As the court below (in considering the effect of an oil payment assignment by the owner of a larger oil payment right) itself stated in *Commissioner* v. *Hawn*, 231 F. 2d 340, 346: "Where the legal effect to be given for tax purposes to what appears in form to be a transfer of an interest in

property is raised, we have the clear teaching of the cases already cited that we must determine whether such transfer is for a substantial interest in the total property owned by the transferor." In making that determination, all of the circumstances are to be considered. *Helvering* v. *Clifford*, 309 U. S. 331; cf. *Commissioner* v. *Sunnen*, 333 U. S. 591.

This so-called "insubstantial transfer" rule was established in decisions involving family gifts, but it is equally applicable to so-called sales to strangers for reasons already indicated (*supra*, pp. 27–29). Under Section 117, the basic inquiry is whether the income derived from a transfer is gain realized on the increase in the value of property. When the transfer for a consideration is of property which is at least primarily an assignment of future income, it is of no consequence that the transfer carries with it some incidental interest in the income-producing (or capital investment) property. The consideration is paid for the right to receive future income, not for an increase in the value of the income-producing (or capital investment) property, unless the transfer is of so much of the transferor's interest that the effect is to shift ownership as related to the entire interest.

For the purposes of applying the insubstantial transfer rule in the present cases to transfers by leasehold and royalty owners, we will assume, contrary to what we have already shown, that taxpayers' oil (or sulphur) payment assignments each carried with them a proportionate part of the assignor's capital investment (or income-producing) property and that the consideration received for the assign-

ments is not depletable. Even on the basis of an assumption so extremely favorable to taxpayers, the assignments are still assignments of future income for a consideration, rather than sales of property within the meaning of Section 117.

We are here dealing with assignments of *assured* future income. Taxpayers' oil and sulphur payment assignments were all made with reference to producing properties. Reasonably accurate estimates of the oil reserves to be produced from those properties, and thus of the oil attributable to taxpayers' leasehold and royalty interests, could be made by modern scientific methods. 32 Taxes, Tax Magazine 494, 500 (1954). The Texas Railroad Commission sets "state oil production quotas" translated "into a specific amount for each field and for each well". *Burford* v. *Sun Oil Co.*, 319 U. S. 315, 320. Thus, at least the approximate rate of production could be forecast and, making allowances for the possible variation in the price of oil, even the approximate time the assigned oil payment rights would pay out could be determined. It is accordingly conceded in four of the cases that the assignments could be expected to pay out within a given time.[24] In the *O'Connor* case, it is a stipulated

[24] The oil payment assignments in the *Wrather* case related to properties in Illinois and Indiana, rather than in Texas, but the approximate pay-out period of those oil payment rights could also be determined.

The estimated pay-out time is stipulated in the *Lake* and *Wrather* cases. (R. 11, 210.) The testimony and Tax Court's findings show the estimated pay-out period in the *Weed* case. (See R. 255.) In the *Fleming* case, the taxpayers have conceded that the estimated pay-out periods could be determined.

fact that both the assignors and the assignee had information available to them which gave them reason to believe that the assignors' royalty interests would produce sums "substantially in excess" of the amount of the assigned oil payment right. (R. 49–50.) In fact, the pay-out of the assigned oil payment right, in the amount of $10,000,000 plus 4 per cent interest, was so assured that the purchaser obtained a $9,990,350 purchase money loan without any security other than a deed of trust on the assigned oil payment right. (R. 48, 68, 70.)

The assignments did not transfer any of the control over production which the taxpayers (with the probable exception of Weed) had under their leasehold and royalty interests.[20] The assignments were temporary transfers at best and did not transfer any substantial portion of the taxpayers' minerals. In the *O'Connor* case, the assigned oil payment right,

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[20] The taxpayers who were leasehold owners (*Lake*, *Fleming*, and *Wrather*) had complete control over production consistently with the terms of the leases involved. See fn. 15, *supra*, p. 31. The taxpayers in *O'Connor* were the owners of a royalty interest which had been retained on the execution of an oil and gas lease (R. 61–62) and accordingly had control over production to the extent that they could enforce the obligations of the lease. The O'Connors' oil payment assignment specifically provided (R. 41) that—

> It is expressly agreed * * * that except as to the right to receive the royalties herein conveyed grantors reserve and retain all the rights, powers and privileges, express or implied, now owned and possessed by them as lessors in such leases.

In all probability, the one royalty interest from which an oil payment right was carved in *Fleming* was also a retained royalty interest.

in the amount of $10,000,000 plus 4 per cent interest, was payable out of about 17 per cent of the assignors' total royalty oil and paid out in 3 years. (Statement, *supra*, pp. 7–8.) In the *Wood* case, the assigned sulphur payment right, in the amount of $0.00833333 per long ton on 6,000,000 of the 21,000,000 remaining long tons or a total of $50,000, was payable out of 25 per cent of the assignor's pooled royalty interest, was expected to pay out in 4 years, and actually paid out in 28 months. (Statement, *supra*, pp. 16–17.) In the other three cases, the estimates of total oil reserves are not shown in the record so as to afford a basis for comparing the amount of assigned oil with the taxpayers' total oil, but it is reasonable to assume that the known reserves were such that they would be nowhere near exhausted until long after the pay-out periods of the assigned oil payment rights. In addition, the assigned oil payment rights were currently payable out of only fractions of the assignors' leasehold oil (and in one instance in *Fleming*, out of royalty oil). In the *Lake* case, the assigned oil payment right, in the amount of $600,000 plus 3 per cent interest, was currently payable out of only 25 per cent of the assignor's leasehold oil and was estimated to and actually did pay out in a little over 3 years. (Statement, *supra*, pp. 5–6.) The several oil payment assignments in the *Fleming* case were payable out of varying proportions of the assignors' oil—6, 8, 25, and 40 per cent and in one instance almost all—and the pay-out periods similarly varied, being 3½ years, 5 years and 8

months, 7 to 8 years, and 10 to 12 years. (See tabulation in Statement, *supra*, n. fn. 7, pp. 11–12.) In the *Wrather* case, the three assigned oil payment rights were payable out of $^9/_{10}$ of the assignor's leasehold oil and were estimated to pay out in from 4 to 6 years. One actually paid out in 4 years and the other two combined in 5 years and 5 months. (Statement, *supra*, pp. 13–14.)

Under these circumstances, it must be concluded that none of the taxpayers' oil (or sulphur) payment assignments transferred such a substantial part of the assignors' leasehold and royalty interests as to warrant treating the consideration received for the assignments as gain derived from a conversion of the increase in the value of those leasehold and royalty interests.

II

IN THE FLEMING CASE, THE SO-CALLED EXCHANGES OF OIL PAYMENT RIGHTS FOR FEE SIMPLE INTERESTS IN REAL ESTATE WERE NOT TAX-FREE EXCHANGES OF PROPERTY OF LIKE KIND WITHIN THE MEANING OF CODE SECTION 112 (b) (1)

In the *Fleming* case, the oil payment assignments were made in return for real estate, rather than for cash. The court below (see *Fleming* opinion, R. 180–187), reversing the Tax Court, held that the transactions were tax-free under Section 112 (b) (1) of the Code (Appendix, *infra*, pp. 59–60), which provides that—

> No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor * * *) is exchanged solely for property of

> a like kind to be held either for productive use in trade or business or for investment.

The inapplicability of this section to the Flemings' oil payment assignments can be demonstrated in several ways.

As we have already shown, the Flemings did not make exchanges of property. They made assignments of future income, which for tax purposes do not constitute transfers of property. While our prior discussion involved Section 117, rather than Section 112 (b) (1), it is unrealistic to suppose that oil payment rights are "property" under a Code provision providing for tax-free transactions if they are not "property" under a Code provision which only accords preferential tax treatment.

Moreover, the language of Section 112 (b) (1) itself seems clearly to preclude treating assignments of future income as exchanges of property. Under that section, the property transferred by taxpayers must be "property held [by taxpayers] for productive use in trade or business or for investment". Such property is necessarily property of the income-producing, and thus capital investment, type. Cf. *Century Electric Co.* v. *Commissioner,* 192 F. 2d 155, 160 (C. A. 8th), certiorari denied, 342 U. S. 954. The underlying assumption of the statute is that the new property is substantially a continuation of the old investment still unliquidated. Treasury Regulations 111, Sec. 29.112 (a)-1 (Appendix, *infra,* pp. 62–63). Accordingly, if the Flemings' oil payment assignments are excludible from the operation of Section 117 as being assignments of future income rather than

transfers of their capital investment (or income-producing) property, the oil payment assignments are excluded from the operation of Section 112 (b) (1) for the same reason. Actually, as already shown (*supra*, pp. 35–36), the Flemings' oil payment assignments were merely arrangements for delayed *cash* payment of the purchase price of real estate plus interest thereon.

The Flemings' oil payment assignments were not transfers of "property held for productive use in trade or business" even apart from the question of whether they were only assignments of future income. The leasehold and royalty interests held by taxpayers were held for productive use in their businesses of producing and selling oil (R. 162, 166), but they did not assign portions of their leasehold and royalty interests as such. They made assignments which created a different type of property interest—oil payment rights. The assigned oil payment rights were of a part of the property represented by taxpayers' leasehold and royalty interests only if and to the extent that they transferred economic ownership of oil in place. If the transfers are of oil, they are expressly excluded from the operation of Section 112 (b) (1) as being of "property held primarily for sale" by taxpayers.

Finally, the oil payment assignments did not transfer property "of a like kind" to real estate. An oil payment right is an "interest in land" only in a rather vague sense; even under Texas law, an oil payment assignment does not convey title to oil in place. *Tennant, Recr.* v. *Dunn*, 130 Tex. 285, 290, 110 S. W.

2d 53, 56. As the court below itself stated long ago in *Standley* v. *Graham Production Co.*, 83 F. 2d 489, 490 (C. A. 5th), certiorari denied, 299 U. S. 593, with respect to an oil payment assignment: "The assignment of this oil *did not create an estate in the land,* but only a lien on the oil after it had been separated from the soil. *Dashko* v. *Friedman* (Tex. Civ. App.) 59 S. W. (2d) 203, and authorities cited therein." (Italics supplied.) An assigned oil payment right is not of the same "nature" or "class" as real estate and that is the basis, as stated in Section 29.112 (b) (1)-1 of Treasury Regulations 111 (Appendix, *infra*, p. 63), for determining whether exchanged property is of like kind. Furthermore, it is implicit in the regulation that, as related to oil interests, only the exchange of "a leasehold of a fee with 30 years or more to run" is sufficiently "like" real estate to constitute a tax-free transaction under Section 112 (b) (1). The court below has itself previously held both that the regulation is valid (*Commissioner* v. *Crichton*, 122 F. 2d 181) and that an oil payment right is not a leasehold or a fee (*Fleming* v. *Campbell*, 205 F. 2d 549, 550).

The present *Fleming* decision (R. 180–187) rests on the same court's decisions in *Commissioner* v. *Crichton, supra,* and *Fleming* v. *Campbell, supra,* as having "decided the question presented here" (R. 187), apparently on the ground that an oil payment right is property "of a like kind" to real estate. However, those decisions have no real bearing on that question. In the *Crichton* case, the exchange was of a *fee* mineral interest for real estate and thus,

as the court below there called it (p. 182), an exchange of "real estate for other real estate". In the previous *Fleming* case, the exchange was of an oil payment right for a royalty interest and accordingly, as the court there stated (p. 550), an exchange "of mineral interests for mineral interests". The fact that a fee mineral interest is property of a like kind to real estate does not also make an oil payment right property of a like kind to real estate. An oil payment right is like a fee mineral interest only in the sense that it is a mineral interest. But a fee mineral interest is like real estate because of its fee characteristic, not because it is a mineral interest. The decision of the court below, holding the *Crichton* and the previous *Fleming* decision controlling here, is thus based on erroneous reasoning.

CONCLUSION

For the reasons stated, it is respectfully submitted that the judgments below should be reversed.

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JANUARY 1958.

APPENDIX

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * *, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

(26 U. S. C. 1952 ed., Sec. 22.)

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General Rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) *Exchanges Solely in Kind.*—

(1) *Property held for productive use or investment.*—No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged solely for property of a like kind to be held either for produc-

tive use in trade or business or for investment.

* * * * * *

(26 U. S. C. 1952 ed., Sec. 112.)

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) *Definitions.*—As used in this chapter—

(1) [as amended by Sec. 115 (b) of the Revenue Act of 1941, c. 412, 55 Stat. 687, and Sec. 151 (a) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Capital assets.*—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (l) * * * or real property used in the trade or business of the taxpayer.

* * * * *

(4) [as amended by Sec. 150 (a) (1) of the Revenue Act of 1942, *supra*] *Long-term capital gain.*—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing net income;

* * * * * *

(b) [as amended by Sec. 150 (c) of the Revenue Act of 1942, *supra*] *Percentage Taken Into Account.*—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or ex-

change of a capital asset shall be taken into account in computing net capital gain, net capital loss, and net income:

100 per centum if the capital asset has been held for not more than 6 months;

50 per centum if the capital asset has been held for more than 6 months.

* * * * *

(j) [as added by Sec. 151 (b) of the Revenue Act of 1942, *supra*] *Gains and Losses From Involuntary Conversion and From the Sale or Exchange of Certain Property Used in the Trade or Business.*—

(1) *Definition of property used in the trade or business.*—For the purposes of this subsection, the term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (l), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

(2) *General rule.*—If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion * * * of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such

gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. * * *

* * * * * *

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

> SEC. 29.112 (a)-1 [As amended by T. D. 5402, 1944 Cum. Bull. 229]. *Sales or Exchanges.*—* * *
>
> Exceptions to the general rule are made by section 112 (b) (1) to (5), inclusive, * * * in the case of certain specifically described exchanges of property in which at the time of the exchange particular differences exist between the property parted with and the property acquired, but such differences are more formal than substantial. As to these, the Internal Revenue Code provides that such differences shall not be deemed controlling, and that gain or loss shall not be recognized at the time of the exchange. The underlying assumption of these exceptions is that the new property is substantially a continuation of the old investment still unliquidated; and, in the case of reorganizations, that the new enterprise, the new corporate structure, and the new property are substantially continuations of the old still unliquidated.
>
> * * * * *
>
> The exceptions from the general rule requiring the recognition of all gains and losses, like other exceptions from a rule of taxation of general and uniform application, are strictly construed and do not extend beyond the words or the underlying assumptions and purposes of the exception. Nonrecognition is accorded by the Internal Revenue Code only if the exchange is one which satisfies both (1) the specific description in the Code of an excepted exchange,

and (2) the underlying purpose for which such exchange is excepted from the general rule. The exchange must be germane to, and a necessary incident of, the investment or enterprise in hand. The relationship of the exchange to the venture or enterprise is always material, and the surrounding facts and circumstances must be shown. As elsewhere, the taxpayer claiming the benefit of the exception must show himself within the exception.

* * * * *

SEC. 29.112 (b)-(1)-1. *Property Held for Productive Use in Trade or Business or for Investment.*—As used in section 112 (b) (1), the words "like kind" have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under such section, be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for such fact relates only to the grade or quality of the property and not to its kind or class. Unproductive real estate held by one other than a dealer for future use or future realization of the increment in value is held for investment and not primarily for sale.

No gain or loss is recognized if (1) a taxpayer exchanges property held for productive use in his trade or business, together with cash, for other property of like kind for the same use, such as a truck for a new truck or a passenger automobile for a new passenger automobile to be used for a like purpose, or (2) a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or a leasehold of a fee with 30 years or more to run for real estate, or improved real estate for unimproved real estate, or (3) a taxpayer exchanges investment property and cash for investment property of a like kind.

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